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July 25, 2011

Ms. Cynthia T. Brown
Director, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, S.W.
Washington, D.C. 20423-0001

ENTERED
Office of Proceedings

JUL 25 2011

Part of
Public Record

Re: Ex Parte No. 705 – Competition in the Railroad Industry

Dear Ms. Brown:

In accordance with the Board's Decision released June 30, 2011 leaving the record open until July 25, 2011 for parties to supplement their testimony, Arkansas Electric Cooperative Corporation (AECC) submits the following information.

1. Service Disruptions.

At the Public Hearing, AECC was asked by the Board whether AECC had experienced delivery problems since the major Joint Line service disruption that began in 2005. AECC wants to clarify that even before the PRB Joint Line derailments of May 2005, it had been experiencing problems associated with increasing cycle times and delivery shortfalls. For example, UP had been falling behind in its deliveries in the last quarter of 2004 and the first quarter of 2005, apparently because it was signing new contracts and electing to use its capacity to handle this new business while delaying fulfillment of existing commitments. The Joint Line derailments made an already unsatisfactory situation worse. This major service disruption continued through the remainder of 2005, all of 2006, and into 2007. Conditions did not substantially improve until the middle of 2007. Shortly thereafter, beginning in 2008,

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reduced traffic volumes associated with the current recession enabled the big railroads to improve the reliability of their service. The levels of service that the big railroads will provide in the future, when traffic volume and growth patterns return to "normal", remain to be seen.

In this context, it is essential to note that during the time when UP was failing to make contracted deliveries to AECC's plants, evidence submitted in this docket by UP shows that the railroad was actually increasing deliveries to other customers. See "Reply Comments of Union Pacific Railroad Company" (May 27, 2011), Reply Verified Statement of John J. Koraleski at 17, Figure 2. The period from 2004-2007 was generally a period of volume and rate growth for the railroads, and UP apparently decided to shift its resources to customers (including new customers) paying higher rates, at the expense of service to AECC's plants at the low legacy rates provided in the existing contract, *which had been reduced even further as a result of harms created by previous UP service inadequacies*. Outside of the deep recent recession, AECC's experience has been that poor service occurs with unfortunate regularity, and cannot be viewed as the short-term consequence of an isolated event.

This highlights how important it is for the Board to hold rail management accountable for inadequate, unreliable and/or inefficient service. Section 10101(9) establishes "honest and efficient management" as a national transportation policy goal.

Competitive access is the best tool available to the Board to deal with poor and/or inefficient service by railroads, such as AECC has received.

2. Competitive Access v. Improved Rate Regulation.

At the Public Hearing, there was discussion about whether rail customers would prefer competitive access, or improved rate regulation. This is a false dichotomy. Shippers are entitled to both reasonable rates and adequate service. They are entitled by statute to viable means to ensure the reasonableness of rail rates. They are also entitled by statute to

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opportunities to seek competitive access where the incumbent monopolist fails to provide adequate and efficient service.

The primary purpose of competitive access is not – as several of the railroads argued in this record – to provide an alternative form of rate relief, but rather to provide a remedy for inadequate service. Rate reasonableness remedies cannot effectively redress the failure of a monopolist railroad to provide adequate and efficient service to a captive customer.

The focus of this proceeding, as described by the Board, is on competition. The record in this proceeding shows that a great many rail-dependent customers do not have the benefit of intramodal competition and that the competitive access rules, as currently interpreted and applied by the Board, effectively prevent rather than support use of competitive access to remedy poor or inefficient service. Therefore, the Board's competitive access rules should be revised to provide an effective remedy for inadequate and/or inefficient service. This should not be viewed as an alternative to, or substitute for, refinements in the Board's rate reasonableness procedures that may also be warranted in light of the evidence presented to the Board by shippers in this proceeding.

3. Pilot Programs.

There was discussion at the hearing that the Board should adopt a "pilot program" for competitive access. However, it was not clear what was meant by a "pilot program". Different people may mean different things when they refer to a prospective "pilot program" for revised competitive access rules. The meaning of this term needs to be clarified.

If a "pilot program" means a program worked out through voluntary cooperation between railroads and customers, in this case it would be a waste of time. The railroads have made clear that they are absolutely opposed to any change in the status quo regarding competitive access. In fact, the big railroads currently seem to be opposed to any cooperation

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with their customers, as is dramatically illustrated by BNSF's recent refusal even to meet with customers to develop a solution to the issue of fugitive coal deposition on the Joint Line. In the Board's decision in Arkansas Electric Cooperative Corp. – Petition For A Declaratory Order, FD 35305, served March 3, 2011, the Board said (at p. 14) that it "expected that railroads and their customers will collaborate to develop a solution that guarantees that loaded cars are fit to travel, while also ensuring that commodity spillage during transport is minimized." Yet BNSF refused to meet with customers to develop such a solution. Earlier this year, AECC and the National Coal Transportation Association (NCTA) invited BNSF and UP to meet with a large group of coal shippers, who represent a majority of their coal traffic, to discuss this issue at the NCTA Spring Meeting in Colorado Springs, but BNSF refused to meet. Instead, BNSF has unilaterally developed a scheme that it seeks to impose on its customers. See <http://domino.bnsf.com/website/updates.nsf/updates-marketing-coal/711FF24E19133BFD862578CD0057F83B?Open>. Voluntary cooperation by the big railroads with their customers has not occurred even when the Board has stated an explicit expectation that it should. Consequently, a "pilot program" for competitive access premised on such cooperation would be a waste of time.

The term "pilot program" might also imply a program covering only limited geographic areas and/or to limited commodities. Such a program would be useful only if experience with a limited program would help in developing more broadly-applicable competitive access rules, and there is no reason to think that such a limited program would do so; it would only delay the development and implementation of the generally applicable rules that are needed. For experience under revised competitive access rules to be a meaningful test of reform, such rules should apply to all geographic areas and all commodities for which competitive access may be appropriate.

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A “pilot program” might mean adoption of temporary revised competitive access rules, with the idea of observing the results of the temporary rules, and then adopting permanent rules based on that experience. Adopting temporary rules, however, would only encourage the railroads to engage in obstructionism and dilatory tactics, particularly if the temporary rules had a specific expiration date. The absolute rejection of competitive access reform by the Class I railroads is amply documented in this record. Moreover, even temporary revised rules would require a time-consuming rule-making process, which would be very inefficient if the process did not result in the adoption of permanent rule changes.

A plausible argument could be made for a “pilot program” that started with reform to one particular form of competitive access – such as reciprocal switching, or through routes – to see how the new regulations work for that form of access, before tackling the other forms of competitive access. However, AECC believes that such an approach to competitive access reform, while feasible, would not be particularly useful.

The statute provides for three distinct forms of competitive access, each of which may be appropriate in particular circumstances. Reforming the rules initially with respect to only one of these forms of access would introduce distortions, because this would encourage shippers to use the reformed type of access, and would give railroads an incentive to argue that a different type of access, still governed by the old rules, was appropriate in the particular case. Such distortions might be tolerable if rules for a single method of competitive access could be adopted expeditiously, but in all likelihood a rule-making process to change the competitive access rules for one form of access would not be materially less difficult and contentious than one dealing with all three forms of competitive access. Rather, focusing on only one form of competitive access would ultimately delay the development of revised rules needed for all three forms of access. Therefore, AECC urges the Board to develop reformed rules for all three forms of competitive access.

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Any changed rules that the Board makes would, of course, like all rules, be subject to subsequent amendment as needed, and in that sense any reform of the competitive access rules would be a kind of "pilot program". Experience under the new rules would determine whether and how they should be further modified to make them more effective. Therefore, the Board should establish a formal monitoring and reporting process, analogous to the process for mergers, and be prepared to make changes in the new competitive access rules based on experience with them.

Further, because of the intransigence demonstrated by railroads in this proceeding, they can be expected to resist implementation of competitive access to the maximum extent possible. Therefore, the Board should establish an expedited process for resolving complaints about non-compliance with any new rules, unreasonable delay, obstructionism, etc.

4. Conduct-Based v. Service-Based Standard.

The railroads argued at the Public Hearing that a "conduct-based" standard must be used by the Board to decide whether a shipper is entitled to competitive access. However, nothing in the statute requires that competitive access be subject to a "conduct-based" standard. The statute authorizes the Board to order competitive access based on public interest and feasibility considerations. Consistent with the broad reliance on market forces envisioned in the Staggers Act, competitive access enables the Board to introduce market forces where needed to address a wide range of problems that may stem from the exercise of market power by railroads that do not face effective competition.

In practice, however, competitive access has failed to achieve its remedial and deterrent potential because the Board has limited the application of competitive access remedies to situations that satisfy its "competitive abuse" standard. The Board has interpreted "competitive abuse" to mean railroad conduct so extreme that the Board's current standard

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has never been satisfied. When the railroads refer to a “conduct-based” standard, they are advocating retention of the status quo, because their “conduct-based” standard really means a “misconduct-based” standard – i.e., the current “competitive abuse” standard – which virtually guarantees that their exercises of market power will never trigger the introduction of remedial market forces. The record in this proceeding shows that under the industry conditions that have evolved the Board should reconsider its approach and apply a less restrictive standard to grant competitive access in the circumstances contemplated in the statutes.

To the extent that the Board thinks it appropriate to consider the behavior of the incumbent monopolist as a factor in the award of competitive relief, what the Board ought to look at is how well the railroad performs in terms of service to the customer. This would be a “service-based” standard, rather than a “conduct-based” one. Under a service-based approach, the question in a competitive access case would be whether the service provided by the incumbent monopolist railroad was as good, in terms of quality, reliability, efficiency, etc., as the service would be in a competitive situation. Thus, an incumbent railroad could defeat a competitive access application by showing 1/ that the relevant attributes (quality, reliability, efficiency) of its service are as good as they would be if there were competition for the movement. If monopoly railroads failed to provide competitive-quality service, they would be at risk of having to face competitive access.

5. Service to “Non-physical Points”.

At the Public Hearing, shippers described a change in railroad practices in recent years in which railroads have generally ceased quoting rates to “non-physical points”. In this context, “non-physical points” refers to locations not presently served by a given railroad, but where the shipper proposes to enable the railroad to serve the location through infrastructure

1/ For the reasons explained in AECC’s Comments, the burden of proof regarding service should be on the incumbent railroad (where the incumbent is a Class I railroad).

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investment (i.e., a buildout). As described, this change has had the effect of discouraging shipper efforts to introduce intramodal competition via buildouts. Without knowing the rate that would be charged for the prospective new rail service, shippers lack the information needed to conduct sound economic analyses of prospective buildouts. This inhibits the willingness of shippers to commit the substantial resources typically required to construct a buildout, and dovetails with the consensus of multiple speakers at the hearing that the pace of pro-competitive buildouts has, in fact, slowed noticeably in recent years.

Chairman Elliott asked what the Board can do about this situation. AECC believes that the Board has clear statutory authority to require railroads to quote rates to such locations. Under Section 11101(a), a rail carrier "shall provide . . . transportation or service on reasonable request". The Board certainly may deem "reasonable" a bona fide request for rates and terms associated with service to a non-physical point to which a shipper proposes to construct a buildout. In doing so, the Board can rely on the fact that under Section 11101(b), the carrier has ample opportunity to specify reasonable relevant terms.

In addition, the Board can and should view any refusal of a carrier to quote rates to non-physical points as being strongly indicative of a diminished level of intramodal competition. Absent unusual circumstances, such as weight or clearance limitations that would preclude the prospective service, a carrier's refusal to provide a quote for traffic from which it would obtain significant contribution implies a tacit (at least) agreement or understanding by the railroads not to pursue each other's exclusively served traffic. This undermines many aspects of the Board's regulation that rely on the presence of vigorous intramodal competition. It specifically provides a basis and need for the Board to revisit assumptions it otherwise may make regarding the effectiveness of intramodal competition in the qualitative market dominance test employed in rate cases, and to employ vigilant oversight to ensure that any award of competitive access actually results in the increased exercise of market forces.

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6. Cost of Capital and Revenue Adequacy.

Discussion at the Public Hearing addressed the possibility of the Board seeking greater analytical input regarding the railroad cost of capital, and the related issue of rail revenue adequacy. AECC's evidence in this proceeding highlighted critical information already developed for the Board in the Christensen Study. Specifically, AECC's opening comments documented how the Christensen Study showed that the major railroads were fully able to supply needed capital by the mid-1990's, long ago satisfying the core element of the applicable statute. See AECC Initial Comments, VS Nelson at 8. Moreover, although Christensen Study authors Eakin and Meitzen submitted reply testimony on behalf of AAR, they did not try to rebut AECC's analysis of the Christensen Study findings on this crucial point. Combined with the fact that the Board's cost-of-capital methodologies are subject to systematic errors associated with changes in the exercise of rail market power (as AECC previously has shown), the evidence in this proceeding should lead the Board to accept that the big railroads have met fully the statutory objective for revenue sufficiency.

The Board's precedents in competitive access and bottleneck issues were formed at a time when it was not known that the Board's mandate to foster revenue sufficiency had been satisfied; revisiting those precedents now is supported fully by AECC's unchallenged analysis of the Christensen Study results.

7. Economic Theory and the Board's Approach

At the Public Hearing, the AAR panel claimed there was "nothing in economic theory" that would justify a change in the Board's approach to competitive access. AAR's broad claim simply ignores the testimony of various economic witnesses, including its own, on a number of fundamental economic issues. The Christensen Study finding regarding revenue sufficiency described above leads to the unavoidable conclusion that earnings materially above the level needed to attract capital have prevailed for much, most, or all of the last 15 years.

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Economic theory does not support such supracompetitive earnings, and specifically postulates that the sustained occurrence of such earnings will create market entry by new competitors. As discussed in AECC Initial Comments, VS Nelson at 12, there is no valid economic theory on which the Board should permit rail earnings above the level required to produce revenue sufficiency. Contrary to AAR's assertion, economic theory guides the Board to facilitate competitive access under current market conditions.

Likewise, while market participants generally accept the proposition that rates on captive coal movements may be subject to substantial mark-ups because of inverse elasticity considerations, the Christensen witnesses have testified (correctly) that due to increasing volumes and declining economies of density, the markups required to sustain revenue sufficiency have been going down. ^{2/} Thus, under economic theory in the context of current known facts, the stable mark-ups highlighted by UP do not demonstrate acceptable pricing behavior, but rather reflect an increasing retention of improper earnings above the level required to sustain revenue sufficiency. Again, economic theory, as well as the National Transportation Policy, would guide the Board to introduce the competition needed to dilute the undue concentration of market power manifest in this situation.

AECC's evidence in this proceeding discussed at length how the resource allocation concerns that provide the foundation in economic theory for differential pricing also necessitate remedial action when the exercise of market power leads to tangible misallocations

^{2/} See, for example, AAR Reply Comments, RVS Eakin/Meitzen at 6: "a lesser markup over marginal cost is needed to achieve sufficient revenues"; and at 10: "A key finding of our revenue sufficiency analysis is that the needed markup has declined in recent years, but the actual markup observed has not declined by as much."

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of resources, including those resulting from inefficient and/or inadequate service. 3/ The same considerations that permit differential pricing basically require that such resource misallocations be effectively addressed. Under economic theory, the Board should recognize differential service and/or efficiency experienced by captive customers as per se indicators of adverse exercises of market power to be curtailed with competitive access.

Lastly, economic theory indicates that competition – not market power – is a central driver of innovation and investment. Corroborating this, the evidence in this proceeding indicates that with the reductions in competition associated with the mega-mergers, railroad costs increased and productivity improvements plummeted. 4/ Once again, economic theory would lead the Board to take a longer term view that encompasses the full benefits of competition, and the detriment to the industry that occurs when competitive pressures are muted or absent, to protect the longer-term financial health of the industry.

3/ AECC Initial Comments, VS Nelson at 17-18, discussed the resource allocation and public interest foundation for differential pricing and for remedial action when the exercise of market power leads to tangible misallocations of resources, including inefficient and inadequate service. AAR offers no disagreement with Nelson's testimony describing how the service inefficiencies and inadequacies to which the competitive access remedies primarily are directed "can rapidly accrue costly deviations from the efficient allocation of economic resources." AECC Initial Comments, VS Nelson at 17. AECC Reply Comments, RVS Nelson at 6-7, discusses the acknowledgement provided by AAR witness Willig of the central importance of efficient resource allocation in determining the public interest. None of the railroad evidence provides a basis on which the public interest problems stemming from resource misallocations can be disregarded.

4/ AECC Initial Comments, VS Nelson at 13-14, discusses the findings from the Christensen Study that plainly show adverse changes in carrier marginal costs and fixed costs associated with consummation of the mega-mergers. AECC Reply Comments, RVS Nelson at 4-6, discusses the dramatic slowdown in the rate of productivity improvement that was associated with the mega-mergers.

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Overall, contrary to AAR's hand-waving, economic theory justifies or requires changes in the Board's past practices, and specifically guides the Board to loosen its restrictive treatments of competitive access and intramodal competition.

8. Bottleneck Issues.

At the Public Hearing and in all of their written submissions the railroads were notably silent regarding the study of the public interest consequences of the Bottleneck Rule that was conducted for CURE by AECC witness Nelson, and which was cited as authoritative by the USDA/US DOT Joint Study referenced by the Board in its notice commencing this proceeding. Nelson's study identified and documented several specific adverse impacts on operating efficiency, system reliability, and infrastructure investments associated with the Bottleneck Rule. AECC Initial Comments, VS Nelson at 22. Indeed, railroad representatives Willig and Sipe in their oral testimony affirmed that there should be mandated competitive access to remedy efficiency problems (which, as the Nelson study documented, form one of the substantial adverse public interest impact areas stemming from the Bottleneck Rule, at least for unit train/trainload traffic). The Board can safely conclude that it is time to revisit the Bottleneck Rule.

9. AAR/ASLRRRA Agreement

Discussion at the Public Hearing addressed the possibility that the AAR/ASLRRRA agreement on paper barrier issues would at least partially obviate the need for shortlines to be exposed to strengthened competitive access practices. While AECC understands that the agreement recognizes unique issues associated with "new business", the Board should consider on a case-by-case basis the impact of the agreement, if any, on the need to impose competitive access remedies on shortlines. In AECC's experience, the principle that shortlines should enjoy freedom to handle new business may conflict with specific terms in specific interchange

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commitments, so the proposition that such traffic is insulated from the exercise of market power by the "parent" Class I railroad cannot reliably be assumed, and needs to be verified.

10. Operational Issues

Discussion at the Public Hearing addressed operational issues that may be raised by the introduction of competitive access. As with the shortline issue discussed above, operational issues can most effectively be considered on a case-by-case basis. As a general proposition, the operational feasibility of existing voluntary access agreements in a wide range of environments (up to and including the broad Shared Asset Areas created in the Conrail transaction), as well as numerous Board-ordered competitive conditions that have been implemented in merger cases, suggest that competitive access normally can be implemented without substantial operational problems. Indeed, the evidence submitted in this proceeding by the Canadian railroads indicated that competitive access achieved through interswitching not only was operationally feasible, but also provided a foundation for service competition. Joint Reply Comments of Canadian National Railway Company and Canadian Pacific Railway Company at 2-3. This validates the role of competitive access envisioned in the statutes for mitigating service inadequacies, and refutes the scare-mongering of the other railroads on operational issues. The Board reasonably can proceed on the belief that any operational issues arising in an award of competitive access would be manageable.


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AECC appreciates the Board's initiative in commencing this proceeding and urges the Board to proceed with revision of its rules as needed to support fully the reliance on market forces in the railroad industry envisioned in the statutes. The time is ripe to do so.

Very truly yours,

A handwritten signature in black ink, appearing to read 'Eric Von Salzen', with a stylized, flowing script.

**Eric Von Salzen
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